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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Telecommunications Division
Market Structure Branch

RESOLUTION T-16773
October 30, 2003

R E S O L U T I O N

Resolution T-16773. Verizon California, Inc. (U-1002-C). Order accepting subject to correction or adjustment Annual Intrastate Earnings Advice Letter Filing in Compliance with Decision 98-10-026, and Decision 02-10-020.

By Advice Letter No. 10475 Filed on April 1, 2003.

Summary

This Resolution accepts Verizon California, Inc.'s (Verizon) intrastate earnings advice letter filing, subject to any corrections or adjustments that may be appropriate as a result of future Commission decisions or actions. Verizon shall file supplement information to satisfy requirements of T-16656 within 30 days of this order.

Since the sharing of excess earnings with ratepayers has been suspended by Decision (D.) 98-10-026, there is no impact on rates as a result of this filing at this time.

Background

New Regulatory Framework (NRF)

In D. 89-10-031, the Commission replaced cost-of-service regulation for Verizon with the New Regulatory Framework (NRF). NRF was centered around a price cap indexing mechanism with sharing of excess earnings above a benchmark rate of return level. It is commonly known as a "price cap" model. The price cap model updates revenues yearly for inflation and expected productivity improvements for the telecommunications industry based on the formula:

R(t) = R(t-1) x (1 + I-X) + or - Z

In this formula, R(t) is the rate to be set for the current year, R(t-1) is the rate in the prior year, I is inflation as measured by the gross national product price index (GNP-PI), X is productivity, and Z is other exogenous cost changes that are beyond the control of utility management and are subject to the Commission's review and approval.

Under NRF, Verizon was given an opportunity to earn a rate of return (ROR) above the traditional ROR used to establish a reasonable profit level to be included in the prices for utility services. The earnings sharing mechanism was adopted to provide a protection to ratepayers from an improperly functioning indexing mechanism. The sharing mechanism employs several ROR thresholds:

A market-based ROR (initially set at 11.50%) that reflects what a reasonable market driven ROR would be for a similarly situated utility with comparable risk.

A benchmark ROR (13% or 150 basis points higher than the market-based ROR) that is higher than the traditional ROR to provide a strong incentive to the utility to operate more efficiently.

A cap (ceiling) ROR (500 basis points higher than the market-based ROR) to protect ratepayers against the indexing mechanism that results in unreasonably high prices that result in excessive profit for the utility.

A floor ROR (325 basis points below the market-based rate of return) to provide comparable protection for shareholders in the event that indexing mechanism results in unreasonably low prices that result in insufficient earnings levels for the utility that are reasonably close to the market-based ROR.

Under this sharing mechanism, Verizon would retain 100% of its earnings up to the benchmark ROR, would share with ratepayers 50% of its earnings between the benchmark and cap RORs, and would refund to ratepayers 100% of its earnings above the cap ROR. Verizon was required to file an advice letter (AL) reporting its intrastate earnings for each year to determine whether shareable earnings exist. The filing was required to be made no later than April 1 of the following year.

Since the sharing mechanism was adopted in D.89-10-031, certain changes have been made to NRF for SBC and Verizon. D. 93-09-038, which resulted from the first triennial review, the Commission eliminated the 50% sharing between the benchmark ROR and the earnings cap ROR, increased the productivity factor in the price adjustment formula applicable to Verizon, and reduced Verizon's ceiling ROR to 15.50%. Verizon was required to refund 100% of all earnings above the 15.50% earnings cap ROR.

The second triennial review resulted in another significant revision to NRF. In D.95-12-052, the Commission set the productivity factor in the price adjustment formula equal to the inflation factor, essentially suspending the price indexing mechanism. The decision also froze the price caps on category I and II services, allowing only price changes that resulted from Z factor adjustments.

Decision 98-10-026, resulting from the third triennial NRF review, suspended earnings sharing effective January 1, 1999, eliminated depreciation reviews and made changes to the Z factor mechanism by phasing out existing Z factor adjustments, eliminating new Z factor adjustments, and established a mechanism that allowed for the consideration of only a very limited set of exogenous costs. The decision continued the rate caps and floors. The Commission continued to require submission of an advice letter each April 1 for the purpose of monitoring ROR.

The Commission is currently conducting its fourth triennial NRF review of Verizon. In Phase I of the current NRF review, the Commission evaluated the results of an audit of Verizon for the years 1996, 1997 and 1998. As a result of the Phase I review, Decision 02-10-020 ordered Verizon to impute “excessive directory earnings” for the purposes of reporting its intrastate rate of return. Additionally, the Decision ordered ORA to immediately commence an audit of Verizon covering the years 1999 through 2002, including determining the audit issues, pension, post-retirement benefits other than pension, depreciation, and income taxes.

In addition, in the Phase II, which is currently pending, includes an examination of Verizon’s service quality, Phase III, the Commission will be addressing the timing of the price cap AL filing, and reviewing the criteria for revising service prices in the first part of Phase III, 3A. In 3B, the second part of Phase III, the Commission will evaluate the NRF mechanisms. The results of Phases II and III are yet to be determined.

VERIZON’S ANNUAL EARNINGS FILING

Pursuant to D. 98-10-026, Verizon filed its annual rate of return AL, which is to be filed every April 1 for the purpose of reporting its actual rate of return (ROR) for the preceding year. The filing was made on a timely basis. Verizon reported its annual ROR for the year 2002 at 20.43%. This ROR included an adjustment for excessive directory earnings as required by D. 02-10-020. However, Verizon noted in its filing that Verizon objects to this adjustment in its entirety. The issue will be addressed in Phase III of the current NRF review. Other references reported in Verizon’s filing included the following rates of return:

Market-Based	10.50%

Ceiling	15.50%
Floor	7.75%

Notice/Protests

Verizon stated that it mailed a copy of AL 10475 to interested utilities and / or parties. AL 10475 was noticed in the Commission's Daily Calendar on April 9, 2003.

The Commission's Office of Ratepayer Advocates (ORA) filed a timely protest to this advice letter on April 29, 2003. According to ORA, prior to the year 2000, Verizon had a revenue sharing contract with its directory affiliate, Verizon Information Services (VIS). Under that revenue sharing arrangement, Verizon receives the majority of the Yellow-Page (directory) publishing revenues, and the amount thereby contributed to Verizon's regulated intrastate earnings of over $100 million. Starting from year 2000, Verizon and VIS changed their publishing contract arrangement from revenue sharing to a fee-for-service contract (FFS). The effect of this change was to reduce Verizon's share of the Yellow-Page revenues from over $100 million to zero, and in some instances, Verizon ended up paying a few million dollars to VIS instead. ORA recommended that the Commission direct Verizon to provide two versions of its intrastate earnings reports in accordance with T-16656. One version would show Yellow Pages directory revenues using the revenue sharing arrangement and other version would show the Yellow Pages directory revenues using the FFS arrangement.

ORA noted that Verizon's AL failed to comply with the Resolution, and only filed earnings assuming the FFS arrangement of Yellow Pages, although Verizon did compute and include the California portion of VIS's excess earnings in Verizon's intrastate earnings as required by D. 02-10-020. ORA also noted that Verizon improperly included its expenses for several Chamber of Commerce expenses in the above-the-line accounts. ORA recommended that the Commission should note that Verizon's year 2002 ROR is subject to restatement and / or modification, pending the Commission's decision in the current NRF Phase III proceeding, and pending the forthcoming audit for years 1999 through 2002.

Verizon believes that the requirements of Resolution T-16656, to report two versions of earnings, with and without imputations of Yellow Pages publishing revenues, has been superseded by D. 02-10-020. Verizon stated that since both T-16656 and D. 02-10-020 addressed the imputation of significant Yellow Pages revenues, D.02-10-020 superseded the prior reporting requirement set forth in T-16656. Phase 1 decision, D.02-10-020, made no mention of continued dual reporting of earnings as required by Resolution T-16656. Verizon reported its earnings as ordered by D. 02-10-020.

Verizon also stated that ORA incorrectly concluded that Verizon improperly included Chambers of Commerce expenses above the line. Although its workpapers include Chamber of Commerce costs, Verizon noted that those costs were removed from regulated intrastate expenses through the workpapers titled “Expense Adjustment Summary” and “Expense Adjustment Descriptions”. Verizon suggested that ORA’s protest should be dismissed. Verizon suggested its AL 10475 should be accepted as filed subject to such changes and modifications as may be ordered in the future.

Discussion

Verizon reported its ROR for the year 2002 to be 20.43%. Although the reported ROR is well above the 15.50% ceiling, there is no impact on rates as a result of this AL since earnings sharing mechanism with ratepayer has been suspended in D. 98-10-026. Whether the earnings sharing mechanism should continue to be suspended, eliminated permanently, or retained is a policy issue that will be evaluated in Phase 3B of current NRF review.

Resolution T-16656 ordered Verizon to submit its intrastate earnings report and its separated results of operations reports on two basis: one with, and one without the Yellow Page directory revenue Verizon would have received had it not changed its contract with VIS. Ordering Paragraph 5 of D.02-10-020 ordered Verizon to impute “excessive directory earnings” in reporting its intrastate ROR, and made no mention of reporting of earnings required by Resolution T-16656. Since D.02-10-020 did not explicitly discontinue the filing requirements per Resolution T-16656, Verizon shall continue to file its year 2002 ROR to include Yellow Pages revenue assuming the prior revenue sharing arrangement.

Although ORA noted that Verizon improperly included its expenses for several Chamber of Commerce expenses in the above-the-line accounts, Verizon confirmed such expenses were removed from regulated intrastate expenses when computing intrastate ROR. We concur with Verizon that such expenses were removed.

AL 10475 was filed in compliance with D. 98-10-026 and D.02-10-020, but did not meet the requirements of Resolution T-16656. The information in Verizon’s AL includes no deficiency other than missing information required by T-16656. Verizon’s reported ROR will be subject to any corrections or adjustments pending the outcome of future audits, Phase III of the current NRF review and future Commission decision. Verizon shall file supplemental information to satisfy the requirements of T-16656 within 30 days of this order.

Findings

1. AL 10475 was filed timely.
2. Verizon reports its ROR for year 2002 including "excessive directory earnings" was 20.43%.
3. A timely protest to this advice letter was filed by ORA.
4. ORA believe that Verizon should continue to report two versions of ROR as required by Resolution T-16656.
5. Resolution T-16656 required Verizon to submit its intrastate earnings report and separated results of operations reports on two basis: one with, and one without Yellow Pages directory revenue.
6. D.02-10-202 ordered Verizon to reflect all excessive directory earnings attributable to Verizon's regulated revenue. D.02-10-202 did not discontinue the requirement of T-16656.
7. AL 10475 was filed in compliance with D. 98-10-026 and D.02-10-020, but did not meet the requirements per Resolution T-16656.
8. Both ORA and Verizon agreed that the regulatory treatment of directory revenue is an issue in Phase 3B of the NRF proceeding. The Commission's decision on the regulatory treatment of directory revenue may impact Verizon's reported ROR.
9. Earnings sharing is currently suspended.
10. The reference RORs are as follows:
    - Market-Based: 10.5%
    - Ceiling: 15.5%
    - Floor: 7.75%

THEREFORE, IT IS ORDERED that:

1. Verizon's Annual Intrastate Earnings advice letter reporting its 2002 rate of return including an estimate of directory revenue shall be accepted subject to any corrections or adjustments that may be appropriate as a result of future Commission decision.

2. Verizon is required to provide supplement information to fulfill the filing requirements of Resolution T-16656 within 30 days of this order.

This Resolution is effective today.

I hereby certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on October 30, 2003. The following Commissioners approved it:

WILLIAM AHERN
Executive Director